Title: "Reputational Risk and Conflicts of Interest in Banking and Finance: The Evidence So Far"

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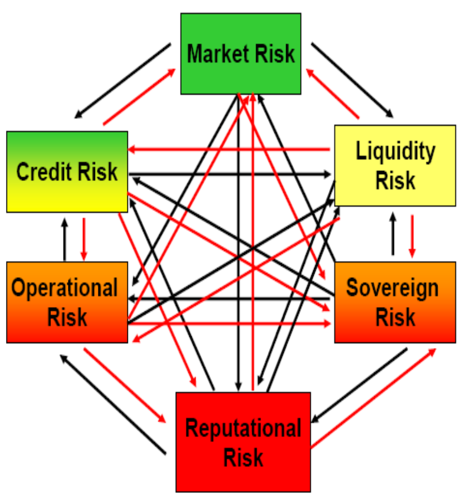
Introduction

In today's globalized markets, a bad name spreads at the blink of a cursor. Professor Ingo Walter of Stern School of Business, New York University and Visiting Professor at INSEAD takes a close look at reputational risk and its adverse impact on financial firms.

What is reputational risk?

In recent years the role of various types of financial intermediaries has evolved dramatically, as capital market deregulation and innovation has resulted in intensified competition, with intermediaries in each cohort competing vigorously with their traditional rivals as well as with players in other cohorts. Consequently, market developments have periodically overtaken regulatory capabilities intended to promote financial stability and fairness as well as efficiency and innovation. It is unsurprising that these conditions would give rise to significant reputational risk exposure for banks and other financial firms involved.

Exhibit 1
A Hierarchy of Risks Confronting Financial Intermediaries



Reputational risk in banking and financial services is associated with the possibility of loss in the going-concern value of the financial intermediary – the risk-adjusted value of expected future earnings. Professor Walter gives a possible working definition as follows:

> *"Reputational risk comprises the risk of loss in the value of a firm's business franchise that extends beyond event-related accounting losses and is reflected in a decline in its share performance metrics. Reputation-related losses reflect reduced expected revenues and/or higher financing and contracting costs. Reputational risk in turn is related to the strategic positioning and execution of the firm, conflicts of interest exploitation, individual professional conduct, compliance and incentive systems, leadership and the prevailing corporate culture. Reputational risk is usually the consequence of management processes rather than discrete events, and therefore requires risk control approaches that differ materially from operational risk."*

In terms of the overall hierarchy of risks (Exhibit 1) faced by financial intermediaries, reputational risk is perhaps the most intractable, with poor data, limited usable metrics, and strong "fat tail" characteristics. In comparison, market risk is usually considered the most tractable, with adequate time-series and cross-sectional data availability, appropriate metrics to assess volatility and correlations, and the ability to apply techniques such as value at risk (VaR) and risk-adjusted return on capital (RAROC).

Sources of reputational risk

Reputational risk, in large part, arises from the intersection between the financial firm and the competitive environment, on the one hand, and the direct and indirect network of controls and behavioral expectations within which the firm operates on the other (Exhibit 2). Financial firms walk a tightrope between the two benchmarks - market performance and corporate conduct. Too compliant in meeting the demands of social and regulatory controls, a firm runs the risk of poor performance in the market, punishment by shareholders, and possibly a change in corporate control. If it stresses unrestrained market performance with questionable market conduct, its behavior may have disastrous results for the firm, its managers and its shareholders.

Exhibit 2
Reputational Risk and External Control Web

At the end of the day, laws and regulations governing corporate conduct are rooted in social expectations as to what is appropriate and inappropriate, which in turn are driven by values imbedded in society that deal with lying, cheating and stealing, with trust and honor, with what is right and what is wrong. These are the *ultimate* benchmarks against which conduct is measured and can be the origins of key reputational losses. Unfortunately, values and expectations change with time, differ across cultures and are sometimes difficult to interpret. There is also additional slippage between society's expectations and the formation of public policy, and the activities of public interest groups. Such activities can result in the system reacting through the political process and a new set of constraints on firm behavior emerging, possibly anchored in legislation, regulation and bureaucracy.

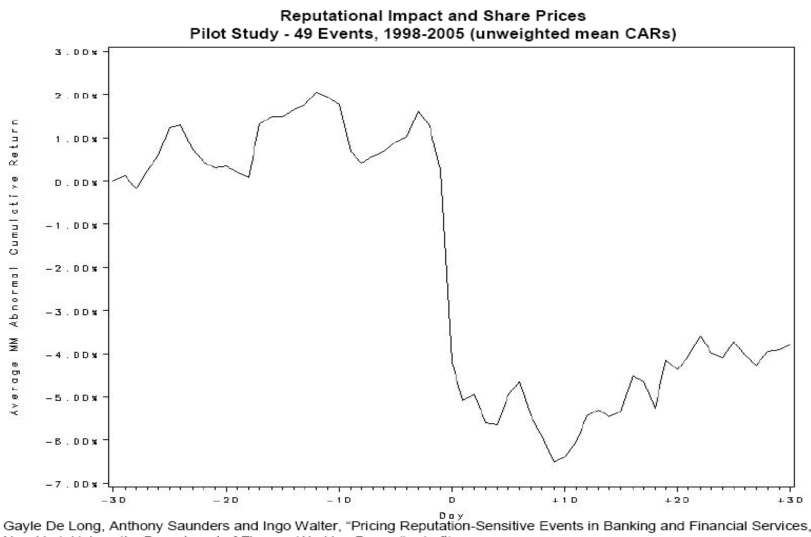
In today's highly competitive market, where profit margins are under constant challenge and there is considerable temptation to break the rules, walking a reputational tightrope is ever more challenging. Performance-driven managers, through compensation and promotion practices, have sometimes unwittingly encouraged behavior that has inflicted major reputational damage on their firms and brought some of them down.

Valuing Reputational Risk

In a reputation-sensitive context, shareholder losses can stem from: (1) Client defections and revenue erosion; (2) Increases in monetary costs comprising accounting write-offs associated with the event, increased compliance costs, regulatory fines and legal settlements as well as indirect costs related to loss of reputation such as higher financing costs, contracting costs and opportunity costs – including "penalty box" suspension by the regulators from particular business activities; and (3) An increases in firm-specific (unsystematic) risk assigned by the market as a result of the reputational event in question. In order to value the pure reputational losses, it is necessary to estimate the overall market value loss of the firm to a reputation-sensitive event and subtract from it the monetary costs just noted – the accounting write-offs, compliance costs, regulatory fines and legal settlements.

A good example from history might be JP Morgan & Co's (JPM) close involvement in the early 1990s with Banco Español de Crédito (Banesto), the fourth largest bank in Spain, when the Spanish central bank took over control of Banesto in December 1993. Calibrating the costs, an "event study" conducted at the time found that a few days before announcement, JPM's return began to decline. Thereafter, an essentially steady decline occurred, with a cumulative loss of 10% of shareholder equity value 50 days

after the announcement. The 10% loss in shareholder value translated into a loss in JPM market capitalization of approximately $1.5 billion versus a direct loss of perhaps $10 million from the Banesto failure. The analysis suggests that the loss of an institution's franchise value can far outweigh an accounting loss when its reputation is called into question.



Gayle De Long, Anthony Saunders and Ingo Walter, "Pricing Reputation-Sensitive Events in Banking and Financial Services," New York University, Department of Finance Working Paper (in draft).

In recent years, event studies have yielded a growing body of evidence as to the share price sensitivity to reputational risk. In a pilot study of 49 reputation-sensitive events, Professor Walter and his colleagues found negative mean cumulative abnormal returns (CARs) of up to 7% and $3.5 billion (Exhibit 3).

Reputational Risk and Conflicts of Interest

One of the key sources of reputational risk in the financial services sector is the exploitation of conflicts of interest which imposes agency costs on others. There are essentially two kinds of conflicts of interest confronting firms in the financial services industry:

- Type-1 - Conflicts between the firm's own economic interests and the interests of its clients. Examples include exploiting conflicts of interest in order to enhance the firm's profitability or market-share, or to transfer risk.
- Type-2 - Conflicts of interest may develop between the firm's clients (or between types of clients), which places the firm in a position of favoring one at the expense of another. Behavior that systematically favors corporate clients over retail investors in the presence of asymmetric information is an example of this type of conflict.

Each of these types of conflicts of interest may arise either in inter-professional activities carried out in wholesale financial markets or in activities involving retail clients.

Professor Walter posits that the broader the range of a financial intermediary's activities, (1) the greater the likelihood that the firm will encounter exploitable conflicts of interest, (2) the higher will be the potential agency costs facing its clients, and (3) the more difficult and costly will be the safeguards necessary to prevent conflict of interest exploitation and the associated reputational risks.

If this proposition is correct, agency costs associated with conflicts of interest can easily offset the realization of economies of scope in financial services firms – scope economies that are supposed to generate benefits on the demand side through cross-selling (revenue synergies) and on the supply side through more efficient use of the firm's business infrastructure (cost synergies). As a result of conflict exploitation the firm may win and clients may lose in the first instance, but subsequent adverse reputational and regulatory consequences can represent serious diseconomies of scope. For example,

the multifunctional role of Citigroup in the WorldCom scandal of the early 2000s triggered large market capitalization losses for Citigroup's own shareholders, only part of which can be explained by a $2.65 billion civil settlement the firm reached with investors in May 2004.

Controlling Conflicts of Interest

Mechanisms to control conflicts of interest are based on either regulation, civil litigation or market discipline - often a combination. These external controls, in turn, form the basis for a set of internal controls, which can be either prohibitive or affirmative, involving in the first instance the behavioral "tone" and incentives set by boards and senior management together with reliance on the loyalty and professional conduct of employees. Nevertheless, both regulatory action and civil litigation are blunt instruments in dealing with exploitation of conflicts of interest in financial intermediaries, conflicts that are often extremely granular and sometimes involve conduct that is "inappropriate" or "unethical" rather than "illegal". Market discipline via reputational impacts on share prices may in fact provide a more consistent and durable basis for internal defenses against exploitation of conflicts of interest than regulatory actions.

The late Milton Friedman used to say that there are two alternatives in getting people to act appropriately – the markets and the police. Markets usually work well all by themselves, and even when they do not the police are well advised to have market discipline working in the same direction.

Conclusion

Market discipline, through the reputation-effects on the franchise value of financial intermediaries, can be a powerful complement to regulation and civil litigation in assuring appropriate firm-level and individual conduct. However, dealing with reputational risk and controlling exploitation of conflicts of interest can be expensive to implement, with costly compliance systems to maintain and informational inefficiency due to various walls between business units and functions imposing significant opportunity costs. Management of certain kinds of conflicts in multifunctional financial firms may also be sufficiently difficult to require structural remediation – for example, divesting incompatible businesses. On the other hand, reputation losses associated with conflict of interest exploitation can cause even more serious damage.

Internally, mechanisms are needed to reinforce the loyalty and professional conduct of employees. Externally, there has to be careful and sustained attention to reputation and competition as disciplinary mechanisms. Professor Walter concludes that, in the end, it is probably leadership more than anything else that separates winners from losers over the long term – the notion that appropriate professional behavior reinforced by a sense of belonging to a quality franchise constitutes a decisive comparative advantage.

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